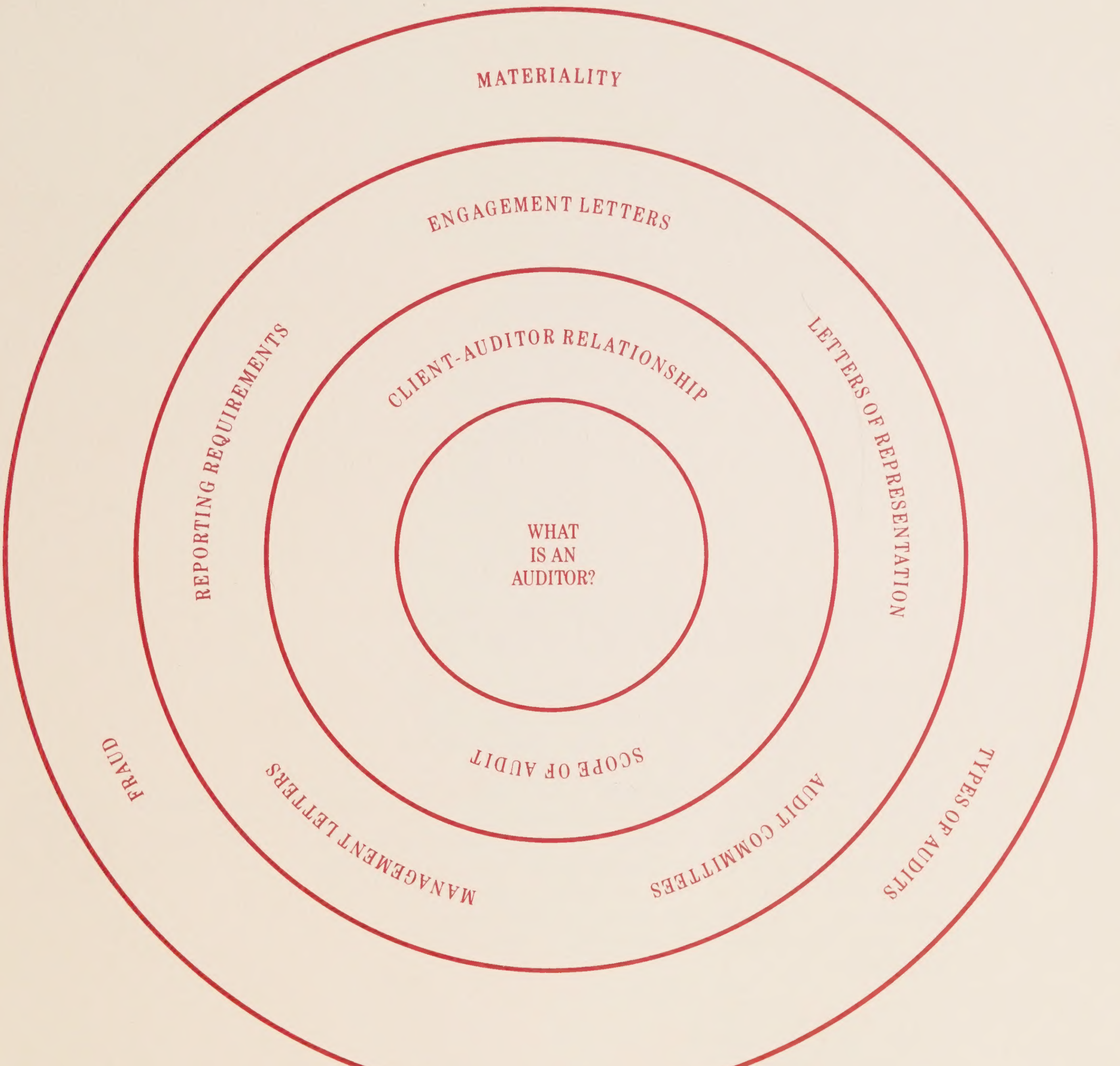
Ontario

A Management Advisory Publication

1 THE MUNICIPAL AUDIT

Responsibility/Communication



November 1986

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THE MUNICIPAL AUDIT

Responsibility/Communication

Ontario

Ministry of
Municipal
Affairs

Honourable
Bernard Grandmaître
Minister

Eric M. Fleming
Deputy Minister
(Acting)

November 1986

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OVERVIEW

Many changes, external influences and developments have taken place pertaining to the audit function in general and to the role of the municipal auditor in particular.

This Management Advisory Publication, the first in a series, is directed to all municipal officials, both elected and appointed and is designed to inform and advise them as to the purpose and nature of the municipal audit function.

Chapter 1--What is an Auditor?

This chapter provides the non-accountant with an understanding of the accounting profession and the auditing environment, including guidelines on selecting an auditor.

Chapter 2--Types of Audits

This chapter provides an understanding of the different types of audits as they affect the municipal environment.

Chapter 3--Engagement Letters

It is in the interests of both municipality and auditor that the auditor has a clear understanding of the scope of his audit. This chapter covers the form and content of audit engagement letters, what they should and may include. A sample engagement letter has been provided.

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Financial Information Return and the Auditor's Opinion on the annual financial statements.

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The purpose of this chapter is to emphasize the importance of an effective communication process between the municipal council, administrative officials and the external auditors, especially in the planning, coordinating, conducting and reporting stages of an audit.

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The focus here is on a description of the overall objective and scope of the audit of the annual financial statements of the municipality and its boards and commissions by an external auditor.

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The purpose, format, content and timing of management letters is discussed here, including to whom they should be addressed.

CHAPTER 1 WHAT IS AN AUDITOR?

The Accountancy Profession

The accountancy profession in Ontario consists of the members of various professional accounting organizations, the main ones being the Chartered Accountants (CA), the Certified General Accountants (CGA) and the Certified Management Accountants (CMA, previously RIA).

To practise as a public accountant in the Province of Ontario, a person must hold a licence issued by The Public Accountants Council for the Province of Ontario (PAC), which is responsible for administering the Public Accountancy Act. To qualify for this licence a practitioner must be a member of The Institute of Chartered Accountants of Ontario (ICAO). Also included is a small group of non chartered accountants who had been in practice at the time the Public Accountancy Act was passed in 1950. Licensure was in fact made available on the basis of membership in the Certified General Accountants Association of Ontario (CGAAO) at that time. Members and students of the CGAAO body as of April 1, 1962 were also eligible for licensure. There are less than one hundred licensed public accountants in the Province who are not chartered accountants.

Organizational Structure

<u>The Public Accountants Council for the Province of Ontario (PAC)</u>
The Public Accountants Council consists of fifteen members; twelve are appointed by the ICAO and three are elected by non chartered accountant licensees. The PAC grants licences, administers and enforces its rules of professional conduct, and acts against individuals or firms practising public accounting in

violation of the Act. The PAC is not involved in accounting education or practice inspection.

The Canadian Institute of Chartered Accountants (CICA)
All chartered accountants in Canada are members of the CICA. Each province reciprocates and recognizes the qualifications attained in each other province. The CICA develops standards, sets admission examinations and co-ordinates the provincial institutes.

Chartered accountants are organized into thirteen institutes together with the CICA. Each of the ten provinces in Canada has enacted enabling legislation creating a professional organization, the provincial institute of chartered accountants (in Quebec, the Order of Chartered Accountants).

Committees of The Institute of Chartered Accountants of Ontario (ICAO)
Within the ICAO are a number of committees staffed on a volunteer basis by chartered accountants to provide for the professional needs of its members and students. The committees that would be of interest to the municipal sector include:

Professional Conduct Committee: This committee has the role of investigator and prosecutor in the disciplining process. It receives the complaint, makes an investigation and, at its sole discretion, either lays a formal charge or sets the matter aside. Aside from the power to admonish, the Professional Conduct Committee itself has no power to discipline. If a formal charge is laid, it presents the case against a member or firm at a formal hearing of the Discipline Committee.

Discipline Committee: This committee conducts formal hearings into the conduct of individual members or firms who are charged with violation of one or more sections of the Rules of

Professional Conduct. The member or firm being charged is entitled to be represented by counsel at formal hearings and to question witnesses. At the conclusion of the formal hearing the Discipline Committee may reprimand the offending member or student, order a fine to be paid to the ICAO , suspend the member or student, or expel the member or student from the ICAO.

Practice Inspection Committee: The main purpose of this committee is to ensure that all members in the practice of public accounting maintain an appropriate level of professional standards. It entails a review of working paper files and related financial statements to ascertain that the firm is adhering to professional standards. It should be noted that its findings are confidential. Where a firm is not following professional standards in certain situations, suggestions and recommendations for improvement may be made. In the extreme, complaints may be laid before the Professional Conduct Committee.

Local Government Accounting and Auditing Committee (LGAAC): This committee was established to consider, study and make recommendations to the Council of the ICAO on any matters concerning existing, proposed or newly enacted legislation or regulation or any other matters affecting the members of the ICAO in the practice of their profession as it pertains to the field of local government accounting and auditing. It also maintains a liaison with the appropriate ministries of the provincial government.

Fees Mediation Service

In addition to the various committees, one of the services offered to the public is a fees mediation service. When a practitioner and his client are in dispute over fees for services rendered they may, by mutual agreement, submit their problem to the fees mediation panel of the ICAO. The parties to

the dispute must both agree to be bound by the decision of the panel. However, the volunteer panel assumes no legal liability to either party. This service is provided to members of the ICAO and their clients free of charge.

THE AUDIT FUNCTION

Accountant versus Auditor

An auditor is a professional accountant who is licensed as a public accountant to provide an independent examination of the books and records of an organization and report on the fairness of the information presented in the annual financial statements.

In the Cohen Report on the Commission on Auditors' Responsibilities, the following distinction is made between accounting and auditing.

> In the broadest sense, the discipline of accounting includes auditing. However, accounting can be described as measuring and reporting the effects of economic activities of individual entities. Auditing, on the other hand, involves an independent examination to determine the propriety of accounting processes, measurements and communications. Stated simply, the accountant prepares financial information; the auditor checks it.
>
> This distinction, however, cannot be made in practice. To perform his function, the auditor must continually evaluate accounting activities and presentations; he must be, and is, trained as an accountant and an auditor. This joint nature extends to the profession as a whole. The term "accounting profession" is generally considered to embrace public accountants--those who offer their services to a variety of clients rather than to one employer. The primary function of public accountants is auditing. [1]

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[1] The Commission on Auditors' Responsibilities: (New York: An Independent Commission Established by the American Institute of Certified Public Accountants, 1978) p.xiii

In Ontario, the municipal auditor is appointed by by-law to audit the annual financial statements. He examines these statements in accordance with generally accepted auditing standards (GAAS) in order to express his opinion as to whether the annual financial statements present fairly the financial position and the results of operations of the entity in accordance with generally accepted accounting principles (GAAP) for Ontario municipalities and their local boards on a basis consistent with the previous year.

Generally Accepted Auditing Standards (GAAS)

Auditing standards help to ensure that the readers (legislature, the public, investment community, management) and the auditor know and agree on what is expected of the auditor. They ensure the suitability of auditing procedures in relation to the objectives to be attained, the quality and extent of their application, and the suitability of the resulting auditor's report.

Generally accepted auditing standards are those established by a recognized standard-setting body. They relate to the professional qualities of an auditor, the performance of his examination and the preparation of his report. The CICA Handbook sets out generally accepted auditing standards for use in Canada (see Appendix A). These constitute the basic professional standards with which an auditor must comply when expressing an opinion on the annual financial statements. They include a general standard of professional competence and examination and reporting standards applied to all situations in which the auditor expresses an attest opinion.

Generally Accepted Accounting Principles (GAAP)

This term refers to principles to be adhered to by various members of the professional or authoritative bodies in the preparation and reporting of financial information. The accounting principles as enunciated in the Municipal Financial Reporting Handbook were developed for application by Ontario municipalities and their local boards and are intended to be used in the preparation of the annual financial statements. The CICA Handbook should be reviewed in conjunction with the Municipal Financial Reporting Handbook.

Need for Auditing

Although municipal audits are required by statute, there are two other fundamental reasons why a municipality should have an external audit:

- an audit provides council and the ratepayers with an independent professional opinion of the financial position and results of operations of the municipality; and

- an audit adds credibility to financial statements and enhances the effectiveness of accounting communications, in particular, for the underwriters and bond-rating agencies who have the responsibility to establish and maintain credit ratings. Such ratings can have a significant impact on the debt-carrying cost and borrowing capacity of the municipality.

Qualifications Required to Audit Municipalities

The Ministry of Municipal Affairs has responsibility for monitoring the financial condition of municipalities in Ontario

and, by extension, to oversee the auditing process as it relates to municipalities. In accordance with the Municipal Act, the Municipal Affairs Act and governing regulation, the Ministry is responsible for issuing licences, monitoring the performance of municipal auditors and revoking licences when warranted.

Currently all municipal auditors are chartered accountants in private practice. The present criteria to obtain a municipal audit licence are payment of an annual $10 fee and a current public accountant's licence. At present there are approximately 190 licensed municipal auditors (firms or sole practitioners).

Auditor's Professional Conduct

An auditor must adhere to established rules of professional conduct concerning the public interest such as those embodied in the codes of each provincial institute or Order of Chartered Accountants. Generally these rules require the auditor to:

- perform professional services with integrity and due care;

- maintain his professional competence;

- be free from relationships that impair his professional judgement or objectivity; and

- disassociate himself from information which he knows or should know is false or misleading.

The auditor should also make every effort to carry out his work as efficiently as possible, take full advantage of contemporary auditing techniques, and report on a timely basis.

How to Choose an Auditor

Although audit standards and principles are uniform within the auditing profession, one audit is not necessarily the same as another. As with any other professional service, the quality of audit and the value derived will differ, depending upon many factors including the orientation of both the auditor and the municipality.

In selecting auditors, the municipal representatives or the audit committee (if there is one) should interview the senior partner and staff who will be assigned to the engagement. The municipality should be satisfied that the individuals and their firm have a solid understanding of the local government environment and the operations of their municipality in particular. Some of the factors that should be considered in selecting an auditor include:

- reputation of the auditing firm, including the opinion of other municipalities;
- quality of audit service;
- knowledge and/or experience in auditing in the municipal sector;
- expertise/qualifications of audit staff;
- audit fees;
- ability to provide any requested ancillary services; and
- accessibility of staff to client.

Subsequent chapters deal specifically with the various aspects of auditing as applied to municipalities in Ontario.

CHAPTER 2 TYPES OF AUDITS

This chapter will provide an understanding of the different types of audits at the local government level. It should be emphasized at the outset that the terminologies are sometimes used interchangeably. In parenthesis are different terms being used to refer to the same type of audit.

External Audit

An external audit is an examination, by an independent professional accountant, of sufficient scope that an informed opinion can be rendered as to whether a set of annual financial statements for a municipality present fairly the financial position and results of operations of that municipality all in accordance with accepted accounting criteria.

Attest Audit (financial statement audit/financial audit/statutory audit)

An audit of the annual financial statements is required by statute for all municipalities and local boards in Ontario. These annual audits are designed to provide, on the basis of sufficient appropriate audit evidence, an independent, objective opinion about whether the annual financial statements, prepared by management, present fairly the financial position and the results of operations in accordance with generally accepted accounting principles for Ontario municipalities applied on a consistent basis.

In expressing an opinion on the annual financial statements of the municipality the implication is that the transactions that have been examined are within the financial authorities of the municipality.

The attest audit is usually completed in two phases. The first, during the year, is often referred to as the interim audit. During this phase the auditor will assess and test the internal controls that management has implemented to protect public funds and assets. The second phase, at the end of the year, will verify the annual financial statements.

Wherever these controls are deemed to be inadequate, the auditors should communicate to Council through a management letter. This letter is discussed in more detail in Chapter 11.

The primary purpose of an attest audit is not the detection of minor defalcations and other irregularities; nor is it designed to provide reasonable assurance of finding defalcations unless they are sufficiently material to distort the fairness of the financial statement presentation. The auditor's main task is to audit the assertions that management has made in the annual financial statements. These assertions include, for example, the representation that assets described in the statements actually exist, are owned by the municipality, are all disclosed and valued in accordance with generally accepted accounting principles for Ontario municipalities. These annual audits are conducted in accordance with generally accepted auditing standards.

The typical auditor's report (see Appendix B), which will be explained in greater detail in Chapter 4, contains two paragraphs. The first (the scope paragraph) identifies the financial statements examined and describes the nature and scope of the examination made by the auditor in accordance with GAAS. The second (the opinion paragraph) states whether the financial statements identified in the scope paragraph present fairly the municipality's financial position and results of operations in accordance with generally accepted accounting principles for

Ontario municipalities and whether those principles have been consistently applied.

Internal Audit

Internal auditing can be viewed as a natural extension of attest auditing, the major distinction being that it is performed by a municipality's own employees. It is often an ongoing systematic appraisal activity to measure and evaluate the effectiveness of other financial and non-financial controls within a municipality. Initially, the role of the internal auditor was to undertake a detailed review and examination of financial transactions on behalf of management, as an element of control. It was to determine if adequate internal systems of control were in place and in operation. A more in depth discussion will be undertaken in a later publication.

Authority Audit

A municipality may not do anything for which it has no express authority. Therefore, Ontario municipalities and their local boards are legally bound to conduct their operations under the authority provided by relevant enabling and incorporating legislation. Legislation may set out directions, conditions and limitations that affect the administration and transactions of these entities and with which they must comply. For example, all government spending, revenue-raising, borrowing and investing activities are undertaken under the authority provided in legislation.

An authority audit examines the extent to which the municipality being reported upon by the auditor has complied with the statutes, regulations and by-laws that govern it. There is increasing demand from readers of financial statements for assurance that the entity being reported on has complied with

legislative and related authorities. Up to now, auditing in the public sector has generally been restricted to the traditional attest audit in which the auditor renders an opinion on the annual financial statements.

At present, Ontario municipalities are required to submit audited annual financial statements and a Financial Information Return that has been subjected to "Accountant's Comments" and "Auditor's Opinion" for particular schedules.

The Canadian Institute of Chartered Accountants (CICA), in February 1985 issued an exposure draft entitled "Auditing For Compliance With Legislative And Related Authorities" which detailed instances where compliance or authority audit opinions are relevant:

- when providing an opinion on compliance with specific legislative and related authorities;
- when providing a report on whether transactions were in accordance with authorities; and
- when providing a report on non-compliance with authorities.

No statutory requirement currently exists for Ontario municipalities to receive an auditor's report pertaining to compliance with legislative authority or adherence to regulations and policy. Up to now, an attest audit was considered to cover, in an implied way, compliance with authority in that if any non-compliance existed that had a significant impact or influence on the reporting entity and it was not apparent from the financial statements or notes appended thereto, then it could be inferred that the annual financial statements did not present fairly and hence the auditor would issue a qualified, adverse or denial of opinion audit report.

It appears that the CICA is moving in the direction of 'Authority' and 'Compliance' audits for public sector reporting entities. Whether these reports/opinions will be compulsory or only suggested is not certain at this time. For municipalities, the decision would rest with the provinces.

Compliance Audit

A compliance audit, which is a component of the attest audit, is an audit of the financial and non-financial activities concerned with adherence to legislative authority, regulations and policy.

It is generally recognized that the statutory financial audit of a municipality's accounts will be concerned to some extent with ensuring that business has been conducted in compliance with certain statutes and regulations. While some provincial statutes direct municipal auditors to audit certain compliance issues, others are silent on the subject. In the absence of specific statutory direction, however, most auditors will address the issue to some degree. It is within an auditor's responsibility for example, to examine the spending authorization limits and signing requirements in a municipality and to audit accordingly.

There are, however, certain issues concerning compliance auditing that have not yet been resolved by the auditing profession. There is no consensus, for example, on the extent, to which an auditor should determine or be responsible for ensuring that the end use of funds is in accordance with the purpose for which they were voted.

Although the auditor should be aware of the laws and regulations, it is not his exclusive responsibility to determine whether all of the legislation has been complied with. It is primarily the responsibility of management, especially the treasurer, to ensure that appropriate authorization is obtained for any transaction

before funds are expended. If, during the audit, the auditor becomes aware that the entity's financial activities have not been in compliance with the applicable legislative requirements, the auditor has a duty to draw to Council's attention this non-compliance in his management letter (which is addressed to Council). Where the non-compliance affects his opinion on the fairness of the financial statements, the auditor has a responsibility to ensure disclosure in the Notes to the Financial Statements or to report such non-compliance in his audit report.

Comprehensive Audit (efficiency/effectiveness/economy audit, broad- scope audit, value-for-money audit, performance audit, or management audit)

The Canadian Comprehensive Auditing Foundation defines comprehensive auditing as follows:

> A comprehensive audit is an examination that provides an objective and constructive assessment of the extent to which:-
>
> . financial, human and physical resources are managed with due regard to economy, efficiency and effectiveness; and
> . accountability relationships are reasonably served.
>
> The comprehensive audit examines both financial and management controls, including information systems and reporting practices and recommends improvements where appropriate. [2]

Whereas an attest audit indicates that the financial statements present fairly what has actually occurred without commenting upon the efficiency of the organization, a comprehensive audit can give assurances about the way things are being managed and can point out areas where improvements can be made.

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[2] Hugh R. Hanson and Jean-Pierre Boisclair, The Role of Auditing in Canadian Municipal Administration, Practices, Perceptions and Challenges; Canadian Comprehensive Auditing Foundation. 1983, p. 4.

Various publications are available from the Canadian Comprehensive Auditing Foundation in Ottawa.

It should be stressed that the existence of any form of audit should never release management from any of its responsibilities.

CHAPTER 3 ENGAGEMENT LETTERS

An audit engagement letter is a form of contract between the auditor (firm or sole practitioner) and the municipality detailing each other's duties and responsibilities in the performance of an audit. The letter is usually prepared by the auditor and submitted to the municipality for agreement. The Head of Council or the Chairman of the Audit Committee confirms in writing to the auditor the terms of the letter of engagement as auditor of the corporation. It is in the interests of both municipality and auditor that the auditor be required to provide such a letter preferably before the commencement of the engagement, to avoid later misunderstandings. A sample engagement letter is provided in Appendix C.

A good number of municipal audit engagements are entered into on a verbal basis without a clear understanding by Council and management not only of their own functions and responsibilities, but also those of the auditor. The extent of the auditor's responsibilities seems to be a source of misunderstanding, as evidenced by disputes where a fraud is uncovered and a hue and cry ensues as to whether the auditor should have detected it.

The use of an engagement letter in the municipal sector has not been widespread, possibly because the by-law appointing the auditor is mistakenly regarded as an agreement when it is more a confirmation of the appointment. It usually provides very little detail of the terms.

Purpose

An audit engagement letter clarifies the objective and scope of the audit, the terms of the engagement, and the respective responsibilities and functions of the external auditor and the

municipality in ensuring the audit function is properly discharged. It should also incorporate the terms of any additional services, particularly accounting services, required by the municipality.

The Council and its management are primarily responsible for the financial viability of the municipality and the management of its affairs. This includes the responsibility for ensuring that adequate internal control, and financial accounting and reporting systems are in place. Despite this basic principle, many municipalities still have two misconceptions on the auditor's role: that the auditor has the responsibility for uncovering fraud and for ensuring the existence of an adequate system of internal control. The second notion, no doubt, arises from the routine review of the internal control system conducted by the auditor. This review is designed primarily to determine the nature, extent and timing of the audit tests for the purpose of developing an audit strategy, and not for detection of errors.

Content

The form and content of audit engagement letters may vary for each municipality, but they should include references to the auditor's responsibility:

- to report to the Council, inhabitants and ratepayers that the annual financial statements either do or do not present fairly the financial position of the municipality and the results of its operations for the year;

- to report that the annual financial statements are prepared in accordance with generally accepted accounting principles for Ontario municipalities set out in the Municipal Financial Reporting Handbook;

- to conduct the audit in accordance with generally accepted auditing standards;

- to identify the entities to be audited;

- to identify the fiscal period to be reviewed;

- to review, test and evaluate internal control, and, where significant weaknesses exist, to report to council in writing, and make recommendations for improvements (this subject is discussed in more detail in Chapter 11);

- to advise the municipality of its primary responsibility for providing adequate accounting systems and records, and internal control systems;

- to emphasize the audit is not guaranteed to reveal fraud, misstatements or irregularities; however, where any fraud, misstatement or irregularity is revealed, to report to Council in writing;

- to indicate that an audit is generally in two parts: the interim audit which involves the review and testing of the system of internal control; and the year-end or financial statement audit for purposes of rendering an opinion;

- to indicate the specific non-audit services to be provided;

- to indicate the auditor's fee for auditing, accounting or other services;

- to discuss the annual result of operations with Council or audit committee and appointed officials; and

- to request that the auditor's appointment has been confirmed by by-law.

Other considerations that may be included are:

- an understanding that municipal staff prepare certain schedules and information;

- an understanding concerning the involvement of the internal auditor, if any; and

- a procedure to be established for an annual review of the timing of the audit activities and completion of the report, and specifics of any non-audit services to be provided by the auditor, such as the preparation of the annual financial statements and the Financial Information Return.

Advantages

The use of an audit engagement letter has a number of advantages, including:

- It reminds the Council of its primary responsibility for providing sound administration and good management. For some municipalities, this may mean attention to the need for a current and reliable accounting and reporting system, and vigilance to improve the internal control system.

- It gives an increased awareness of the above by the Council which would raise the level of professionalism of the staff.

- It serves as a formal documentation of the auditor's responsibilities.

- For the municipal treasurer, the letter's emphasis on management as the municipality's responsibility may support the treasurer in any initiative to improve financial reporting.

CHAPTER 4 REPORTING REQUIREMENTS

This chapter addresses the present "state of the art" with respect to an auditor's reporting requirements upon being engaged by a municipality as the auditor for the corporation. It also discusses the future possibilities in improving both the present reports prepared by auditors and the present understanding and education of users as to the limitations inherent in the reporting process.

All entities being audited would prefer to obtain what is known as a "clean" opinion--in other words, an unqualified opinion. There are many users, however, who do not understand the limitations to the assurance a "clean" opinion is giving them. There is still a great deal of education of users required and a need to simplify the auditor's report so that it is more informative to the average user.

Present Types of Reports

In connection with the municipality's annual financial statements and the Financial Information Return (FIR) the auditor will issue an "Auditor's Report" and/or an "Accountant's Comments" respectively.

A separate "Auditor's Report" is required for the following:

- the annual financial statements which present the financial position and results of operations of the municipality;

- all other financial statements which are required to be audited under other sections of the Municipal Act, or other Acts; and

- all schedules which are specifically required to be audited separately under any authority, such as the grant information schedule in the FIR (Schedule 13 or 14). (See also Chapter 6 for other specific reporting requirements.)

Auditor's Report

There are four types of opinions that can be given in an auditor's report: unqualified, qualified, adverse or denial. The most common one is the unqualified opinion.

Unqualified, Or "Clean" Opinion

In this form of opinion, the auditor states that the annual financial statements of the entity do "present fairly the financial position and results of operations in accordance with generally accepted accounting principles for Ontario municipalities (or for Ontario Hydro-Electric Commissions or other) applied on a basis consistent with that of the preceding year." The auditor has made no qualification of the opinion, or in other words has not said "except for...," or "subject to...."

There is a danger that some users will interpret the auditor's unqualified opinion to mean that the entity being reported upon is financially sound, or that it is being run efficiently. The auditor is merely saying that the annual financial statements are fairly reflecting what actually happened. It is the responsibility of the user of the financial statements to analyse the information correctly to meet his specific objectives and requirements. Also, the user must understand that an unqualified opinion does not also mean that there are no major uncertainties facing the entity in the future.

Qualified Opinion

When the auditor issues a qualified opinion on the financial statement/schedule, it is usually to identify problems arising from:

- accounting policy changes;
- departures from Generally Accepted Accounting Principles;
- going concern
- inadequate disclosure;
- internal control;
- other information in annual reports;
- substance over form; and
- uncertainties.

(Examples of such problems are given in Appendix D to this chapter.)

The opinion would then contain some qualifying statement, such as: "In our opinion except for the (problem stated in a Note) these financial statements present fairly ...." or "In our opinion subject to (the outcome being resolved) these financial statements present fairly....."

Denial Of Opinion

An auditor will give a denial of opinion where the problems above are not reasonably ascertainable or the effects on the annual financial statements are not measurable.

Adverse Opinion

An adverse opinion states that the "annual financial statements do not present fairly" and is obviously not frequently used. Management would most often come to an agreement with the auditor on the specific problem(s) giving rise to the adverse opinion.

Accountant's Comments

In cases of certain schedules, or in the case where the auditor is not required to actually audit the statement or schedule, he will attach a report called "Accountant's Comments" whereby he will indicate the limitations of his review.

A typical "Accountant's Comments" in the Financial Information Return will read as follows:

To the Ministry of Municipal Affairs

Our examination of the financial statements of the Corporation of ____________ for the year ended December 31, 19__, was made for the purpose of forming an opinion on the financial statements referred to in our auditors' report to the Members of Council, Inhabitants and Ratepayers dated __________, 19__.

At your request, we have performed the following procedures in connection with Schedules 1 to 11 of the Financial Information Return of the Corporation of_________________ for the year ended December 31, 19__.

(a) We have compared the amounts disclosed on these schedules to the books and records of the (name of municipality) and found them to be in agreement;

(b) we have added and cross-added all schedules; and

(c) we have cross-referenced the information on the schedules where applicable.

The above-noted schedules have not been subjected to the auditing procedures applied in the examination of the financial statements

and accordingly we do not express an opinion on the fair presentation of this statement.

____

Chartered Accountants
Licence No.

(City), Ontario
Date (last day of auditors' field work)

Future Developments

It is generally felt among users that the auditor's report should be simplified by the use of non-technical language, and that it should be more descriptive. Certainly standardized phrases or paragraphs could still be used; however, the auditor would select those which would be applicable to the individual client. The auditor could thus communicate the differences in types of services, assurances, audit techniques, and any other matters which are relevant to proper understanding of the financial information presented and the auditor's responsibilities thereon. In other words, the auditor would have more flexibility in reporting on presenting the actual financial position of the municipality. It would also allow him to explain any limitations in his report.

The flexibility in the auditor's report would, in addition, allow the consideration of changes in the auditor's role to be incorporated more easily. The general financial environment is changing at an ever-increasing pace and requires all persons concerned to increase their level of sophistication in financial reporting, analysis and control.

CHAPTER 5 CLIENT-AUDITOR RELATIONSHIP

An effective communication process between the municipal council, administrative officials and the external auditors is vitally important for an efficient and useful audit to take place.

This applies equally to both small and large municipalities. A little time at the beginning of the audit to ensure all parties understand the audit process and its purpose can result in many benefits for all parties concerned, some of which are:

- reduced audit time;
- fewer misunderstandings due to better relationships;
- improved management information; and
- more current reporting.

An audit gives elected officials and management the opportunity to establish close working relationships with individuals who specialize in governmental financial management and who are familiar with the latest developments in the field. It is important to establish an environment whereby there is a continuing dialogue, communication and trust so that the Council, management and auditor will consult on an "as-needed" basis. This would often reduce year-end problem situations.

If local officials wish to maximize the benefits that can result from an audit, they have to take an active role. Generally speaking, in order to achieve the benefits of retaining the same auditor over a number of years, the minimum economical period is from three to five years, barring any unusual problems with the auditor. It will obviously take longer the first year to establish effective communications with new auditors, Council and the administration. A rapid turnover of auditors should raise red flags.

Planning/Coordinating

Someone should be assigned responsibility for planning and coordinating auditing activities, either on a formal or informal basis. This person (or persons in the case of an audit committee) will be the liaison between all interested parties.

When there is communication between the auditor, Council and administrative officials there will be less likelihood of missed deadlines, duplicated work, overly detailed scope and other related problems.

Appendix E illustrates a fiscal year-end flow chart. Obviously this is a general guide but there are very few of these steps which do not apply regardless of the size of the municipality.

The audit should be coordinated so that local personnel can assist the auditor as much as possible to reduce audit fees. For example, municipal personnel can document by flow-chart or narrative the financial systems-payroll, purchasing, accounting and tax collection. They can also prepare schedules and documents required by the auditor, including reconciliations and analyses of accounts. Such schedules and documents often exist for the municipality's own financial and analytical purposes, but where there is lack of communication, the auditor may be unaware of this and may duplicate efforts of the municipal staff.

Such planning and coordinating efforts also assist the municipality in understanding the extent of the auditor's work. Audit fees can range widely in municipalities of approximately the same size due to the varying amounts of assistance provided to the auditor by the municipality.

Twelve items to be considered in the planning/coordinating phase for each audit (discussed in detail in other chapters) are:

- specific audit requirements to be met;
- audit scope (systems or detailed transactions);
- auditing standards;
- time period under review;
- report submission date;
- specific tasks to be performed by internal staff;
- form of the auditor's report;
- financial statements and schedules;
- report on internal accounting controls;
- management letter;
- distribution of report; and
- consideration of public disclosure.

It is also during this phase that elected officials may request the auditor to concentrate on a specific area of concern, such as suspected fraud, or a particular project to which they wish to give additional attention.

Other items which could also be discussed and considered during this phase are:

- Level of experience of staff employed on the audit.

- To the extent possible, was there staff continuity from the previous year?

- If there are internal auditors, was their work coordinated with the work of the external auditor? Is the auditor satisfied with the quality of the internal auditor's work?

- The involvement of audit personnel in the provision of special services to the municipality should be considered.

- Are there any audit procedures which can be performed before the year-end to expedite the reporting process?

Conducting the Audit

During the course of the audit, problems may arise that will require additional communications between the auditor, Council and management.

Problems of an interpersonal nature can develop during the audit since at this very busy time of year tensions are more likely to affect all personnel involved. The source of the tension could be insensitive auditors, over-protective staff members, or misunderstandings of responsibilities. These problems can better be solved if there is good communication between the municipal officials and the auditor.

Reporting

<u>During the Audit</u>

Policies should be established to ensure that problems requiring corrective action are relayed to the lowest level of employees authorized to take corrective action. Any high-level communications should be accompanied by the responses of those officials most affected by them. This is most important, since the auditor should ensure that any problem areas have been communicated and discussed to make sure that they are indeed a problem and are not covered off by compensating controls or procedures or both.

Any evidence of irregularities, such as fraud or misrepresentations, should be taken to Council and the appropriate level of authority.

Completion of the Audit

Upon completion of the audit the auditor should meet with local officials to review:

- the draft financial statements in detail;
- any unresolved audit questions (which may also affect the drafts);
- the presentation of reports to be made to the public by Council; and
- the letter of representation.

This meeting should also provide an opportunity to clear up any misunderstandings and any matters still outstanding. It also provides the municipal officials with an opportunity to discuss their assessment of the quality of the auditor's work and present any comments they may have. Many problems if discussed at this time could be resolved on the spot instead of growing out of all proportion.

Enquiries should be made by municipal officials to determine that:

- the auditor received full cooperation from all management personnel, i.e., there were no attempts either covert or overt to restrict the scope of the auditor's work;

- there were no significant disagreements with management as to disclosure or treatment of any items;

- any significant unusual transactions were handled properly;

- there were no other matters which in the opinion of the auditor require investigation;

- all municipal activities and funds were audited;

- all related-party transactions were examined, validated and disclosed;
- the auditor was not aware of any defalcations/fraud, or illegal transactions;

- if there were other auditors involved, that the relationship is clear. To what extent did the auditor review the work performed by the other auditors? and

- there were no additional reporting requirements of regulatory authorities, such as the Ministry of Municipal Affairs, or other ministries, for example, Annual Return for Cemeteries.

CHAPTER 6 SCOPE OF AUDIT

The scope is the cornerstone of an audit. It is the foundation the auditor builds on to reach an opinion on the financial statements of an entity. The scope of an audit contains two elements:

- what is to be audited: the financial statements of the entities which are subject to audit; and

- extent or depth of audit: the standards, tests and procedures used in the performance of the audit.

A municipal auditor must examine and express an opinion on the following:

- Consolidated Balance Sheet and Consolidated Statement of Operations of the municipality and its consolidated local boards, commissions and enterprises;

- Balance Sheet and Statement of Continuity of (Consolidated) Trust Funds;

- Financial statements of each non-consolidated local board, commission and enterprise; and

- Financial statements of those consolidated local boards which, by reason of specific legislation, still require a separate auditor's report and statements, i.e. Business Improvement Areas, Parking Authorities and Library Boards.

The auditor gathers and evaluates sufficient evidence to express an opinion by performing the examination in accordance with

generally accepted auditing standards; and using such tests and other audit procedures considered necessary in the circumstances.

Objective

The purpose of the audit is to enable the auditor to express an independent opinion as to whether the annual financial statements present fairly the financial position and the results of operations for the fiscal year of the entity being audited.

To this end therefore the scope of the audit should be designed to satisfy the following concerns:

Financial Statements:

- that reported assets and liabilities exist and are properly valued;
- that reported transactions took place and the amounts are properly recorded and allocated;
- that there are no unrecorded assets, liabilities or transactions;
- that assets are owned and properly safeguarded; and
- that financial statement presentations are in accordance with prescribed accounting principles.

Internal Control:

- that a reliable accounting system and internal controls exist;
- that the system and controls operate effectively and are applied consistently; and
- that management policies and procedures are effective and are not in conflict with accepted practice.

Responsibilities

The auditor is not specifically responsible for the detection of fraud; this is the primary responsibility of management. However, the normal tests and procedures of a properly conducted audit should uncover instances of, or potential conditions for, material fraud except where collusion exists. Chapter 8 discusses fraud in greater detail.

The annual financial statements and accompanying notes are the responsibility of management <u>regardless of who prepares them</u>. The auditor's responsibility is to render an independent opinion on the statements, including the notes. Readers and users of financial statements rely on the auditor's opinion when determining the credibility of the financial information presented. For example, bank managers use the statements in assessing credit risk and investors in determining stability and performance.

Limitations placed on the scope of the audit, for whatever reasons, will affect the type of opinion rendered. Similarly, failure by the auditor to establish sound guidelines for the scope of the audit will result in an opinion based on an inadequate examination of the client's systems and records.

The auditor should disclose any such limitations or deficiencies and their effect on his opinion. If no disclosure is made and the statements are subsequently found to be misleading, albeit unintentionally, there could be serious repercussions on the auditor and possible third party liability.

Guidelines

To avoid any misunderstanding between auditor and client, the terms of the audit should be set out in an engagement letter which has been discussed in Chapter 3.

In conducting an audit, the auditor must comply with generally accepted auditing standards (GAAS) which are applicable to all audits whether in the public or in the private sector. These standards may vary in number and in wording from country to country, but are recognized internationally by professional accounting bodies as the code an auditor should follow in performing an audit. In Canada, GAAS are set by The Canadian Institute of Chartered Accountants (CICA) and are shown in Appendix A of this publication. The main points are summarized as follows:

- adequate technical training and proficiency in auditing;
- exercise of due care;
- objectivity and independence;
- proper planning and execution;
- proper supervision of assistants; and
- issuance of a report.

In addition to GAAS, there are statutory requirements and regulations pertaining to the powers and operations of entities which have a direct bearing on the scope of the audit and the auditor's report. In particular, municipalities and their local boards, commissions and enterprises must operate within the provisions of various Acts and related regulations.

Consequently, the municipal auditor must be familiar with the principal statutory provisions, related regulations and reporting requirements relevant to municipalities in Ontario, and must plan

the scope of the audit to recognize the uniqueness of the municipal environment.

Factors

Various factors influence the planning of a municipal audit, but the key factor is accountability.

Financial Accountability
Municipalities and their local boards obtain their funding from the public mainly through realty and business taxation, user fees and provincial and federal grants. Members of Council and local boards exercise control and use of these funds through the budget and policy decisions on the provision and level of services.

Accountability to the inhabitants and taxpayers of the municipality and, to a large extent, provincial and federal ministries, is provided through the approved budget and the audited annual financial statements.

Operational Accountability
Department heads, line managers and supervisors are responsible for the physical provision of services within the limits authorized in the budget and the policies approved by Council. They are accountable to Council and the local boards through internal budget, management and project reports. It is the municipal treasurer's specific responsibility, among others, to prepare for audit annual financial statements which comply with the requirements of the Ministry of Municipal Affairs.

Statutory Restrictions
Municipalities and their local boards, commissions and enterprises can only operate within the restrictions imposed by provincial legislation. In particular, money by-laws may require approval of the electors and the issuance of debentures and the

entering into of commitments beyond the term of Council require the approval of the Ontario Municipal Board. Councils may also pass by-laws setting internal procedures for approval and authorization of financial transactions.

Preparation

To decide the scope of the audit, the auditor must be familiar with the organization and procedures of the municipality. This includes an awareness of:

- lines of authority and accountability;
- budget procedures and controls;
- accounting systems and related internal controls;
- expenditure approvals;
- internal management and budget reports;
- performance indicators;
- signing authority levels; and
- legislation pertinent to the financial operations of the municipality and its local boards, commissions and enterprises.

Although the auditor's report does not specifically refer to these areas, knowledge of the procedures, practices and controls are requisite in determining the approach to the audit. Much of the information obtained will also relate to the management letter which is discussed in Chapter 11.

Organization

The auditor should plan the audit, recognizing the guidelines and factors involved, to cover the following general points:

Ensure adequate coverage of all operations of the municipality relevant to the statements being audited. This will include

those local boards and other bodies to be included in the consolidated statements and those which require separate reports and statements.

- Determine if the accounting records and other source documents provide sufficient information to produce and support the required financial statements.

- Check the validity and reliability of the information used to prepare the statements.

- Decide if the statements adequately disclose the required information and are prepared "... in accordance with the accounting principles prescribed for Ontario municipalities applied on a basis consistent with that of the preceding year."

Methods

The methods used to implement the audit plan are known as audit procedures. They are the steps followed to achieve the objectives of the audit and involve evaluations, checks and tests of the client's systems and operations. They will vary in degree and extent depending on the circumstances and the judgement of the auditor.

The actual methods used by the auditor may vary, but the general pattern is as follows:

- Describe system of internal control (flow charts, narratives) and examine for weaknesses.

- Test selected transactions to evaluate the effectiveness and reliability of the accounting system and internal procedures and controls. This evaluation will indicate

the adequacy of the system and areas which may require special attention.

- Decide what type, number and extent of additional audit tests and procedures are necessary based on the results of the evaluation. The degree of confidence the auditor has in the effectiveness of internal control, in particular, directly affects the amount and extent of testing.

- Test the validity of transactions and balances by examining accounting records, source documents and by obtaining confirmation from third parties. The auditor will not check all transactions, but only enough, in the auditor's judgement and using accepted sampling techniques, to ensure that the sum total of possible errors does not exceed predetermined limits of materiality. Materiality and sampling are discussed in greater detail in Chapter 7.

- Verify ownership and proper valuation of assets and confirm they are properly safeguarded and adequately insured.

- Verify existence and proper valuation of liability.

- Analyse overall performance for trends and reasonableness. Any unusual variations will require further examination and testing.

- Verify year-end accounts receivable balances, particularly taxes receivable, by requesting confirmation from the individual debtors.

- Verify other year-end balances by performing such tests as are necessary considering the nature of the item and

materiality. This will include, among others, physical counts of inventory, fixed assets, securities and cash on hand.

- Determine the extent of audit required for local boards, commissions and enterprises. Factors to be considered are the specific legislative requirements for the audit of a particular body, and the materiality of operations in relation to the consolidated statements.

- Ensure that the financial transactions tested are within the statutory powers of the municipality and that Ontario Municipal Board and other approvals were obtained where required.

- Ensure compliance with internal policies and procedures particularly regarding spending and signing approvals and authorizations for those items tested.

- Ensure that the municipality is following the accounting principles prescribed for Ontario municipalities. The annual financial statements and accompanying notes should comply with the recommended format and disclosure requirements of the Ministry of Municipal Affairs.

When the auditor has completed the examination and is satisfied with the findings, an auditor's report is prepared attesting to the fairness of the financial position and the results of operations. The type of opinion given, that is, unqualified, qualified, denial or adverse, is discussed in Chapter 4.

The auditor also should prepare a management letter commenting on weaknesses in accounting methods, internal control, failure to obtain required approvals and other matters relevant to the audit. The management letter, which is the subject of Chapter

11, should also include recommendations for improvement in those areas found deficient.

CHAPTER 7 MATERIALITY IN AUDITING

Dictionaries define materiality as something having real importance or great consequences, essential, relevant and pertinent. The CICA Handbook states:

> Materiality may be judged in relation to the reasonable prospect of its significance in the making of decisions by readers of the financial statements. If the item might reasonably be expected to affect the decision, it should be deemed to be material.

Other accounting and auditing publications give similar definitions using similar terminology.

There is no implication in these definitions that materiality is related solely to specific dollar amounts. While the dollar value is an important consideration, it is not the controlling factor. It is the item itself and the nature of the item that determine materiality. In many instances it is a judgement call based on both the dollar amount and the circumstances.

There are differences in the application of materiality for accounting purposes and materiality for auditing purposes.

Materiality in Accounting

The accountant, in preparing the financial statements, is concerned with the presentation of financial information in itemized form in accordance with prescribed accounting principles and policies on a consistent basis from year to year. There are also requirements for the disclosure of such other information pertinent to the statement figures and to the operations of the entity. Materiality measures are applied to individual items and their overall effect on the statements.

The intent is to enable users of the statements to reach decisions based on the assumption that all relevant information is adequately disclosed, reasonably complete and free from material error.

Materiality in Auditing

The auditor's objective is to report on the financial statements as presented and to assure the readers that the information shown gives a fair and reliable picture of the financial position and operations of the entity. Concern about materiality is related to the statements as a whole and not necessarily to individual items.

The element of cost is an important consideration in the audit function. The more detailed the audit, the higher the cost to the client. Consequently, the auditor must try to provide reasonable audit assurance at reasonable cost. Audit procedures for each engagement should be based on the auditor's evaluation of systems and controls and should be designed to minimize the risk of material errors escaping notice. Conversely, immateriality is not a defence for errors which should have been found in the normal course of an audit.

Materiality in Local Government

Municipal Accounting

Municipal treasurers are responsible for the preparation of the financial statements following prescribed accounting principles and policies. Materiality is influenced by classification and disclosure requirements applied on a consistent basis.

For example, the consolidated statements show the total accumulated surplus or deficit of the municipality and its local boards. A note to the financial statements, required by the

Municipal Financial Reporting Handbook, analyzes this total by general categories as a minimum level of disclosure. However, if a substantial part of the total is the result of the operations of a particular local board or services to a designated group of ratepayers, then materiality may justify a more detailed disclosure for the information of readers.

The reporting and disclosure policies of the Handbook are minimum requirements. The treasurer must decide if expanded disclosure is necessary or desirable because of materiality or unusual circumstances and the possible effect on users of the statements.

Municipal Auditing

In determining materiality guidelines the auditor must be familiar with the financial reporting and disclosure requirements of municipalities. Knowledge of the principal statutes and regulations governing the powers of municipalities and their local boards is also essential.

As in private sector audits, the auditor, in his report, assures readers that the audited statements present fairly the financial position and operations of the municipality. The implication is that they are also free from material errors.

Guidelines

There are no set guidelines for determining materiality; it is a judgement decision based on professional knowledge and expertise. However, the auditor should plan the audit bearing in mind the nature of municipal entities, the reporting intent of the financial statements, and the unique problems associated with determining materiality in a municipal audit.

A municipality's annual financial statements are a report by the Council to the inhabitants and ratepayers of the municipality.

They are an accounting of the administration and management of public funds by both elected and appointed officials. The statements are also used by other interested parties including provincial ministries, particularly the Ministry of Municipal Affairs, the Ontario Municipal Board, financial institutions, bondholders and creditors.

In a municipal audit materiality is seen to be especially important because public funds are involved. Material errors, omissions or discrepancies can have a critical effect on the funding required to provide municipal services and amenities. They directly affect property taxes, credit ratings, grant eligibility and potential growth through land development for residential, commercial and industrial use.

Level of Materiality

Some publications suggest that an acceptable level of materiality for non-profit organizations is one-half of one percent of normal gross revenues. However, the auditor must use his own judgement based on an appraisal of the management and operations of the entity being audited. The municipal auditor will probably base the level of materiality on one of the following: taxation revenue, population, households or mill rates.

Testing for Materiality

The auditor must decide the materiality level applicable for each audit using professional judgement and knowledge of the operations of the entity. To make the client aware of what is to be accomplished, the auditor should discuss with the client the level of materiality to be used and the probable extent of testing required. However, the auditor selects groups or categories of transactions for testing without informing the client of the method of selection. This preserves the auditor's

independence and objectivity and prevents the client from anticipating which transactions will be tested.

There are two main techniques used to determine the size of samples required as a representative selection of total operations: statistical sampling and judgemental sampling. Statistical sampling uses mathematical techniques and statistical tables to select sample sizes. In judgemental sampling, the auditor selects sample sizes using personal judgement and expertise to obtain a representative selection.

Both techniques use similar methods in planning, selecting and evaluating samples and both allow the auditor to express assurance that the sum total of uncorrected and undiscovered errors does not exceed the materialilty level chosen. Statistical sampling is usually only used in large volume audits although in some cases a combination of the two techniques may be appropriate.

The auditor tests the samples and analyzes the errors to compare found errors with the materiality level. If a higher incidence of errors is found, the auditor may have to expand the sample and testing to achieve the required confidence in the results. The errors should also be analyzed as to type and frequency in order to pinpoint the reasons and to determine what improvements are necessary to the internal systems and controls.

Along with statistical and judgemental sampling, the auditor will also often use substantive testing for items such as revenues, e.g., assessment x mill rate = tax revenue; dog tags issued x rate = dog tag revenue; investments x interest rate = investment revenue.

The auditor is not only testing for dollar errors, but for compliance with statutory provisions and regulations and

management policies and procedures. Although compliance is dealt with in Chapter 2, it is worth mentioning here that non-compliance and actions beyond the statutory powers of the municipality can have as great a material effect on the statements as can dollar transactions. For example, failure to obtain required approval of the Ontario Municipal Board for the undertaking and long-term financing of a capital project could have serious repercussions on the financial stability of the municipality.

General

Current reporting practices do not require disclosure of the materiality standards used in the preparation or audit of the financial statements. Consequently, users of the statements have the right to assume that the auditor did use appropriate levels of materiality and that an unqualified opinion implies that the statements are free from material error.

CHAPTER 8 FRAUD

Financial fraud is one of the most persistent problem auditors face today. This chapter will deal only with the auditor's responsibilities.

When misappropriation of public funds is uncovered in a municipality, it may receive widespread attention, regardless of the amount involved. Because of this sensitivity there is a tendency for ratepayers and politicians to perceive the auditor's responsibility for the detection of fraud as being somewhat greater than that indicated by professional literature. However, standard auditing techniques are not always effective in detecting fraud or determining the full extent of a financial fraud.

Although this chapter will be focusing on fraud, it is important to understand at the outset the difference between fraud and error. The Canadian Institute of Chartered Accountants Handbook makes the following distinction.

"Fraud" refers to acts committed with an intent to deceive involving either misappropriation of assets or misrepresentations of financial information either to conceal misappropriations of assets or for other purposes, by such means as:

- manipulation, falsification or alteration of records or documents;
- suppression of information, transactions or documents;
- recording of transactions without substance; and
- misapplication of accounting principles.

"Error" refers to mistakes affecting the financial statements, such as:

- arithmetical or clerical mistakes;

- misapplication of accounting principles; and
- oversight or misinterpretation of facts.

Auditor's Responsibility for Fraud Detection

The prevention and detection of fraud and error is primarily a management responsibility. The auditor has no separate or additional responsibility to detect fraud or error.

Since audits generally involve testing samples rather than checking every item, there is no guarantee that fraud will be detected. Therefore, there is an unavoidable risk that some fraud and to a lesser extent some error may remain undetected. Audits, however, do have a major deterrent effect on the possibility of fraud. The conduct of management and other employees will be influenced by the prospect of its eventual scrutiny by an objective third party.

Although auditors must ensure that the annual financial statements present fairly the financial position of the corporation, they do have a responsibility for the detection of fraud that would result in materially misleading financial statements if such fraud could be detected by the application of generally accepted auditing standards.

If the auditor performs a diligent audit and evaluates the financial statements according to their conformity to generally accepted accounting principles, the professional responsibility to detect fraud is fulfilled. However, if the auditor suspects that fraud exists, generally accepted auditing standards require him to perform additional procedures to either support or dispel his suspicion.

The essential basis for an explicit statement on the independent auditor's responsibility for the detection of fraud is that the

users of financial statements should have the right to assume that audited financial information is not unreliable because of fraud and that management maintains appropriate controls to safeguard assets.

Professional standards explicitly require that the auditor extend the audit procedures of the examination, if indications are that material fraud may have occurred. The sequence of procedures is as follows: First, the auditor is to discuss the matter with a level of management at least one level above those involved. If, after the discussion, there is reason to believe there may be a material fraud, the auditor must determine that the Council or audit committee is aware of the circumstances and then attempt to obtain sufficient evidence to confirm the presence or absence of fraud. If the auditor cannot determine whether unconfirmed, but suspected fraud would be material to the financial statements, the auditor's report must be qualified or a disclaimer of opinion issued. Either report may indicate the possibility of an unconfirmed fraud.

Disclosures of illegal acts in auditor's reports derive from the obligation to render an opinion on the financial statements and not from any obligation to inform legal authorities. However, auditors who discover patently illegal acts immaterial to financial statements must inform Council. If they conclude that Council has not taken appropriate action and believe the matter serious enough to warrant withdrawing from the engagement, they should consult with legal counsel as to any further action.

A diligently performed audit is no guarantee against undetected management fraud. Professional literature makes it clear that auditing procedures, appropriately applied, cannot be expected to detect management fraud in all cases. This caveat reflects the fact that audits are necessarily performed on a sampling basis. Selective testing of transactions is necessary if the cost of

auditing is to bear some reasonable relationship to its expected benefits. The caveat also reflects the fact that forgery, collusion and unrecorded transactions can be remarkably effective tools for fraud because they are extremely difficult to detect, especially when there is no reason to suspect that they are being employed.

Prevention of Fraud

The development of appropriate internal controls is a much more effective and less costly method of preventing and detecting fraud than is the extension of audit procedures.

Prevention of fraud is founded on four closely related functions.

- A sound, comprehensive system of internal control

  A comprehensive system of internal control prescribes that transactions should be recorded based on adequate documentation and requires appropriate review and authorization of those transactions. A system of internal control also provides for reconciliation of subsidiary ledgers (for example, accounts receivable and inventory) to control accounts and to the extent practicable appropriately segregates duties among various employees. A system of internal control should be implemented whereby one person checks the work of another. Internal control will be discussed in greater detail in another publication.

- An alert, capable and independent auditing team

- A strong, involved, investigative Council or audit committee

- An internal audit department

  An internal audit department that performs comprehensive examinations in key areas of a municipality's operations is likely to detect both defalcations and management fraud in areas that it examines. It should report to either the Council or audit committee or to a senior executive removed from the accounting function. The internal audit department may also have a deterrent effect on individuals who might otherwise be tempted to steal funds or manipulate the financial statements.

Under the Municipal Act, a municipality is required to obtain fidelity insurance which indemnifies a municipality against losses that are discovered and that are the result of employee defalcations. A secondary benefit of employee bonding is the investigation of an employee's background that the insurance company often makes prior to issuing a bond.

CHAPTER 9 AUDIT (OR EQUIVALENT) COMMITTEES

In the private sector, an audit committee is a required sub-committee of the board of directors of a company that offers securities to the public (shares, bonds, debentures). Its principal purpose is to review the company's affairs primarily by critically examining the audited annual financial statements prepared by the management. This procedure provides added assurance to the shareholders and other interested parties that the company's operations are being run properly and reported fairly. The establishment of an audit committee in such companies became mandatory in Ontario in 1970 following the collapse of the Atlantic Acceptance Corporation in 1965.

Municipal Sector

There are certain duties and functions related to the audit function which should be carried out annually by the Councils of municipalities. The formation of an audit committee may be appropriate for a Council of a larger municipality, whereas in a relatively small municipality Council itself may wish to perform the annual duties of the audit committee or delegate them to an existing committee such as the finance committee. Council need not necessarily form another committee of Council. The comments which follow, therefore, relate to the functions carried out, and the choice of the term "audit committee" is used to apply to such committees of Council or to Council itself.

At present, there is no legislation requiring an audit committee for Ontario municipalities. However, the purposes served by audit committees are sufficiently important to favour their formation.

An audit committee acts as an advisory body carrying out critical review functions on behalf of Council. A 1981 Canadian Institute of Chartered Accountants research study indicated that audit committees or their equivalent would strengthen procedures used by Council in approving financial statements particularly in view of the large amount of public funds under their control. The study also suggests audit committees should be required for all municipalities or as an alternative, the external auditor should be required to meet with Council at least once a year before approval of the annual financial statements.

Purpose

The objectives of an audit committee are to:

- help Council meet their fundamental responsibilities of protecting the municipal assets and managing operations as efficiently as possible;
- provide better communication between the auditor and Council and promote better understanding of the audit process;
- enhance the external auditor's independent position;
- increase the credibility and objectivity of the municipality's financial report; and
- strengthen the role of the Council and committee members.

Composition

The composition of audit committees can vary, the only suggestion being a minimum number of three members. The membership is normally restricted to elected members of Council, although it may be complemented by one appointed officer who may attend as required by the committee and can provide much continuity and background.

Another suggestion is to appoint a citizen from outside the municipal organization, the expectations being that such a person would bring a fresh approach and special expertise.

Responsibilities and Functions

The scope and functions delegated to an audit committee will depend on each Council's wants. The committee should be constituted by a by-law which provides the terms of reference of its responsibilities and functions. Generally it should have unrestricted and complete authority to delve into any affair of the municipality with full access to the management and auditor. It should maintain minutes of its meetings and submit written reports to Council or Council as a committee of the whole. Normally, the meetings coincide with the stages of audit: first, before the commencement of audit to review the audit program and the estimated audit fee; second, after the interim audit to discuss the auditor's findings on internal control, and third, after the completion of the audit to review the annual financial report, management letter and final audit fee. There should be no set number of meetings since the committee should convene whenever circumstances demand such a meeting.

The functions of a municipal audit committee may be categorized under the following grouping:

Related to the Audited Annual Financial Report

- Review the audited annual financial statements in depth with management and the external auditor; if satisfied that they present fairly the financial position and results of operations, recommend their approval to Council.
- Review any changes in accounting principles and practices followed by the municipality.

Related to the Work of the Auditor

- Discuss with the auditor the annual evaluation of the internal control systems and the recommendations for improvements; obtain a management letter addressed to Council; obtain management's response to the recommendations; deal with any unimplemented recommendations from prior years.
- Discuss extent, timing and completion of audit including the level of materiality to be used.
- Review estimated and final audit fee.
- Recommend to Council the change of the municipal auditor if management questions the competence of the incumbent auditor and the committee confirms the view. The recommendation to appoint a new auditor would follow an adequate inquiry into the auditor's competence and reputation.
- Review the problems and restrictions encountered by the auditor and degree of cooperation received.
- Promote cooperation between the management and the auditor.
- Review letter of representation.

Related to General Administrative Oversight

- Enquire fully into any activities or transactions that may be illegal, questionable or unethical, and into the municipality's control procedures to ensure that such activities are being guarded against.
- Review adequacy of staffing in relation to both number and competence for accounting and financial responsibilities.
- Review the overall reasonableness of expenses of the Chief Administrative Officer and of Council members (the C.A.O. can review the reasonableness of other officers' expenses).

Related to the Work of the Internal Auditor

- Review the reporting relationship of the internal auditor within the organization. Provision should be made for the internal auditor to meet with the audit committee without management present, at least once a year. The internal auditor should also have free access to the committee or its chairman, and be responsible for bringing to the committee's attention any actual or potential problems on a timely basis.
- Review goals and plans, including the nature and extent of work, and the degree of integration with the external auditor's work.
- Follow up significant recommendations made by the internal auditor to management concerning improvements and the management's response.

The value of an audit committee is gaining wider recognition for its contribution to financial stability. This trend, together with current audit thinking, suggests its broader acceptance in the municipal sector.

CHAPTER 10 LETTERS OF REPRESENTATION

Financial statements are the representation of the municipality and not of the auditor. Therefore, it is important that the municipality clearly recognize that it is fully and primarily responsible for their accuracy. In submitting the statements and in making available to the auditor the underlying records and evidence, the municipality makes implied representation with regard to their reliability. Generally accepted auditing practice requires that the auditor impress upon the client the responsibility which the municipality assumes. This takes the form of written representation or certificates which are signed by the appropriate top official usually the Chief Administrative Officer or the Treasurer of the municipality and submitted to the auditor at his specific request. A letter of representation is one kind of competent evidence, but it is not sufficient in itself to provide the auditor with a reasonable basis for forming an opinion.

Purpose

The letter of representation provides written evidence that the auditor has made certain inquiries of management; ordinarily it documents oral responses given to the auditor, thus reducing the possibility of errors or misunderstandings. Examples of issues covered in a letter of representation include:

- that appropriate statutory requirements have been complied with (see item 7, Appendix F);
- that inventory has been correctly determined and accounted for (see item 4, Appendix F);
- that current assets will realise the values attributed to them and that all liabilities are disclosed (see item 5, Appendix F).

Written Representations

The letter of representation illustrated in Appendix F incorporates the written representations that should ordinarily be obtained by the auditor. The letter should be modified to meet the circumstances of the particular engagement and the nature and basis of presentation of the financial statements being examined. For example, if the auditor is reporting on the consolidated financial statements, the written representations obtained from the municipality should specify that they pertain to the consolidated financial statements. If the auditor is reporting on the unconsolidated entities' annual financial statements as well, the letter should also extend to them.

Written representations relating to management's knowledge or intent should be obtained when the auditor believes they are necessary to complement other auditing procedures. For example, after the auditor has performed tests for unrecorded liabilities and has not detected any, written representation should be obtained to document that management has no knowledge of any liabilities that have not been accrued. Any liabilities known to management but not accrued, through oversight, would be brought to the auditor's attention in this manner. Such a written representation, however, does not relieve the auditor of responsibility for planning the audit to check for possible material unrecorded liabilities. Information may be unintentionally overlooked or intentionally withheld from the auditor. Accordingly, the auditor must still perform all the usual tests to corroborate the accuracy and reliability of representations made by management.

Dating and Signing

The letter of representation should be addressed to the auditor and should be dated as of the date of the auditor's report. Letters of representation should ordinarily be signed by the Chief Administrative Officer or the Treasurer. The signature of other members of management will suffice, however, in those circumstances in which the auditor is satisfied that those persons are responsible and knowledgeable about the matters covered by the representations.

Scope Limitations

In rare instances, management may refuse to furnish a written representation that the auditor believes is essential or may refuse to sign the letter of representation. Auditors must consider the effects of a refusal to furnish a written representation or their ability to rely on other management representations. Executives are expected to understand their legal and ethical responsibilities for financial statement representations. Thus, they should also understand that the letter of representation only specifies some of those responsibilities but does not increase them. Refusal to sign the letter must be taken as a signal of withheld evidence or of inadequately understood responsibilities; either destroys the basis for an unqualified opinion.

Summary

It is important to recognize that these representations in no way reduce the auditor's responsibility to discover or verify the matters referred to in such representations. It is a valid piece of corroborative evidence because an auditor is entitled to rely on an assumption of competence and integrity of his client's executives.

CHAPTER 11 MANAGEMENT LETTERS

Management letters are issued as an important additional professional service of the auditor since although auditors are not required by generally accepted auditing standards to issue this letter, their findings can be as important a feature or by-product of the audit as is their opinion on the financial statements. Good auditing practices suggest that management letters should be provided.

In the course of their evaluation of internal control and completion of the year-end audit, auditors may observe deficiencies in internal control, potential sources of other revenues, inefficiencies in administration such as lack of financial planning, and other related matters. Any instances of non-compliance to statutes or regulations and/or other irregularities such as fraud must also be noted in the management letter.

The treasurer should make use of the auditor's expertise on an informal basis to discuss matters which are not significant enough to be included in the management letter and to take advantage of the auditor's knowledge of how other municipalities operate.

Content

A management letter could be divided into two separate sections - major items for consideration by Council and minor items suggested to the treasurer. This will ensure that some items appearing minor in the judgement of the auditor are brought to Council's attention since they may be of more significance to Council than the auditor may realize or may have additional

ramifications. This division would also serve to highlight the areas of most concern.

The letter should set out any areas of concern, describe the situation explaining the impact or effect of the deficiencies and give a recommendation that may include a suggestion for improvement. The auditor's view on the real or potential impact of the identified weaknesses should be given as to their effect on staff performance, service delivery, tax rates, and the municipality's financial position. All items included in the management letter should be discussed with the treasurer (and audit committee if there is one), and the resulting responses to the items should be incorporated in the letter. In some instances the auditor's recommendations may support the treasurer's position re changes in staff.

It is important to note that, whenever a new auditor is engaged, the first management letter is likely to be extremely long. However, the more detailed and explicit the letter, the more effective it is likely to be in strengthening current performance, and anticipating and forestalling future problems. The auditor's recommendation may simply be that a certain subject be studied in-depth, in which case Council can direct the treasurer to prepare a report for future discussion and evaluation.

A covering letter or the memorandum itself should also communicate some of the following additional explanations:

- the recommendations arise out of the normal audit work related to the expression of an opinion on the financial statements and did not constitute a complete report on internal control for management purposes based on an exhaustive study;

- the normal audit work would not necessarily detect all internal control weaknesses;

- notwithstanding any control weaknesses mentioned, the audit procedures were as extensive as necessary for the auditor to report on the financial statements;

- the suggestions and comments outlined concern systems only and are not intended to reflect on the competence or integrity of the client's personnel;

- there are inherent limitations to any system of internal control (e.g., the existence of collusion cannot be identified); and

- there is always the risk of future deterioration in present controls, which is the reason for internal control systems being evaluated annually.

Many of the foregoing points can and should be communicated verbally as well.

Reporting Obligation

Management letters should be addressed to the Council for the municipality with a copy to the treasurer (and audit committee if there is one). To emphasize again, all items should be discussed with the treasurer before inclusion in the letter to ensure that items are not brought to Council's attention which are insignificant or are covered by other compensating procedures which are unknown to the auditor or improperly perceived. This would also give the treasurer an opportunity to respond.

Ideally, a management letter should be issued after the interim audit, which is conducted to evaluate internal control systems,

with a follow-up letter upon completion of the year-end audit. Auditors frequently, however, issue one letter after the financial statements have been completed incorporating the results of both the interim and year-end audit.

APPENDIX A

GENERALLY ACCEPTED AUDITING STANDARDS
(Extract from The CICA Handbook--Volume II)

General Auditing--Section 5100

STANDARDS AND PROCEDURES

.01 Auditing standards are different from auditing procedures. Auditing standards relate to the auditor's qualifications, the performance of his examination and the preparation of his report. Auditing procedures, on the other hand, are the specific acts or steps performed by the auditor to attain his objectives in the particular audit engagement.

GENERALLY ACCEPTED AUDITING STANDARDS

.02 . Generally Accepted Auditing Standards are as follows:

General standard

The examination should be performed and the report prepared by a person or persons having adequate technical training and proficiency in auditing, with due care and with an objective state of mind.

Examination standards

(i) The work should be adequately planned and properly executed. If assistants are employed they should be properly supervised.

(ii) There should be an appropriately organized study and evaluation of those internal controls on which the auditor subsequently relies in determining the nature, extent and timing of auditing procedures.

(iii) Sufficient appropriate audit evidence should be obtained, by such means as inspection, observation, enquiry, confirmation, computation and analysis, to afford a reasonable basis to support the content of the report.

Reporting standards

(i) The scope of the auditor's examination should be referred to in the report.

(ii) The report should contain either an expression of opinion on the financial statements or an assertion that an opinion cannot be expressed. In the latter case, the reasons therefor should be stated.

(iii) Where an opinion is expressed, it should indicate whether the financial statements present fairly the financial position, results of operations and changes in financial position in accordance with an appropriate disclosed basis of accounting, which except in special circumstances should be generally accepted accounting principles. The report should provide adequate explanation with respect to any reservation contained in such opinion.

(iv) Where an opinion is expressed, the report should also indicate whether the application of the disclosed basis of accounting is consistent with that of the preceding period. Where the basis or its application is not consistent, the report should provide adequate explanation of the nature and effect of the inconsistency.

(SEPT. 1975*)

APPLICABILITY OF THE STANDARDS

.03 The auditing standards in paragraph 5100.02 apply to engagements in which the objective is the expression of an opinion on financial statements. The general and examination standards are also applicable to other types of attest engagements.

.04 The general standard in paragraph 5100.02 is intended to express the spirit of the related rule(s) of professional conduct of each provincial Institute or Order, to which rule(s) the auditor is referred.

DISCLOSED BASIS OF ACCOUNTING

.05 Reporting standard (iii) in paragraph 5100.02 contains a reference to "an appropriate disclosed basis of accounting, which except in special circumstances should be generally accepted accounting principles". THE AUDITOR'S STANDARD REPORT, Section 5400, describes circumstances where the auditor should express his opinion as to the conformity of the financial statements with generally accepted accounting principles. There are special circumstances where a different basis of accounting may be appropriate, for example in financial statements prepared in accordance with regulatory legislation or with contractual requirements such as may be set out in trust indentures or buy/sell agreements.

.06 In special circumstances where a basis of accounting other than generally accepted accounting principles is appropriate, the auditor would express his opinion as to the conformity of the financial statements with such appropriate disclosed basis of accounting. The auditor would express a reservation of opinion on financial statements which did not disclose information appropriate and adequate in the circumstances.

Editorial change--July 1979

APPENDIX B

AUDITOR'S REPORT

To the Members of Council,
Inhabitants and Ratepayers of
The Corporation of
The Township of Ontario

I have examined the consolidated balance sheet of the Corporation of the Township of Ontario as at December 31, 198X and the consolidated statement of operations for the year then ended. My examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as I considered necessary in the circumstances.

In my opinion, these consolidated financial statements present fairly the financial position of the Corporation of the Township of Ontario as at December 31, 198X and the results of its operations for the year then ended in accordance with the accounting principles prescribed for Ontario Municipalities applied on a basis consistent with that of the preceding year.

Address of Auditor
Date of report

Chartered Accountants

Municipal Auditor's Licence Number XXX

APPENDIX C
A SAMPLE ENGAGEMENT LETTER

Head of Council and Council
The Township of Ontario
Ontario, Ontario

Dear

As a result of our conversation on (date), we are summarizing our understanding of the terms of our engagement as auditors of the Municipality of Ontario for the financial year ending December 31, 198X.

As statutory auditors, we are required under the Municipal Act to examine the annual financial statements prepared by the municipality for presentation to the members of Council, inhabitants and ratepayers, and to express our opinion thereon. In forming our opinion we will perform such tests as we consider necessary to satisfy ourselves that:

- the underlying accounting records are reliable and sufficient as a basis for the preparation of the annual financial statements, and
- the financial information is adequately disclosed in the financial statements.

The nature and extent of our tests will vary according to our assessment of the system of internal control.

The report will cover the activities of all committees of Council and the following consolidated local boards, municipal enterprises, utilities and joint local boards under its control:

- (list)

and the following non-consolidated entities for which the municipality is responsible for the preparation of the annual financial statements:

- (list)

Our audit will be planned and conducted in accordance with generally accepted auditing standards in Canada to enable us to express our opinion on the financial statements. Because an audit involves testing, not detailed checking, and because of other inherent limitations of an audit and of any system of internal control, there is an unavoidable risk that defalcations and other irregularities may remain undiscovered. Any significant irregularities which we detect will be reported to you.

The responsibility for the preparation of financial statements, including adequate disclosure in accordance with generally accepted accounting principles established in the Municipal Financial Reporting Handbook consistently applied, is that of the Council and management. This includes the maintenance of adequate accounting records and internal controls, the selection and application of appropriate accounting policies, and the safeguarding of the assets of the municipality. As part of our audit process, we will request from you written confirmation concerning representations made to us in connection with the audit that the assets and liabilities, and revenues and expenditures are correctly and fully disclosed.

Our examination will include a study and review of your municipality's system of internal accounting control. The purpose of the study and review of the internal accounting control system is to determine the scope of our audit engagement and is not performed to detect all errors in the processing of information. On the basis of our study and review of the internal accounting control system, we will make suggestions, where appropriate, for improving the system. If we should discover material weaknesses in the design or the execution of the system, we will disclose these weaknesses to you in writing.

In addition we will review the Financial Information Return for the municipality and report on certain schedules required by the Ministry of Municipal Affairs.

Also, we will carry out such bookkeeping as we find necessary, prepare the financial statements and perform any other services as arranged with the Council.

An estimate of our fees will be as follows:

- audit services	$________
- bookkeeping services	$________
- preparation of financial statements & reports	$________
- any other services	$________

We would appreciate your reviewing the contents of this letter and, if it is in accordance with your understanding of the arrangements, returning one signed copy for our records.

Yours truly,

____

Auditor

WE agree with your understanding of the terms of your engagement as set out in this letter.

____

Municipality's name

____

Signature--Head of Council or Chairman of Audit Committee

____

Date

APPENDIX D

QUALIFIED OPINIONS: EXAMPLES OF CAUSES

The auditor would qualify the opinion in the Auditor's Report if any or all of the following conditions were present.

Accounting Policy Changes

- a change in an accounting principle without proper justification of the alternative as preferable.

Departures from Generally Accepted Accounting Principles

- if management decided to use an accounting principle which is not a generally accepted accounting principle (for example, writing off fixed assets in an electric public utility).

Going Concern

- if the auditor has reason to believe that the entity will have difficulties meeting its financial obligations. In public life, a municipality would likely never be allowed to go bankrupt, but there certainly have been cases where their financial viability has been questioned, and they have been put under supervision.

Inadequate Disclosure

- if the auditor has reason to believe because of lack of disclosure of certain items or contingent liabilities, or any other matter, that the presentation in the annual financial statements is misleading.

Internal Control

- if accounting controls are so lacking that the financial

information produced by the accounting system cannot be audited. (Denial of Opinion)

Other Information in Annual Reports

- if the financial statements are to be included in an annual report, the auditor should review the information to ensure that it does not conflict with anything of which he may have knowledge.

Substance over Form

- the auditor must use judgement in the evaluation of transactions which may be correctly shown as to the form of the transaction but may differ in substance.

Uncertainties

- if the financial statements are affected by a material uncertainty, the outcome of which cannot be reasonable determined. ("subject to")

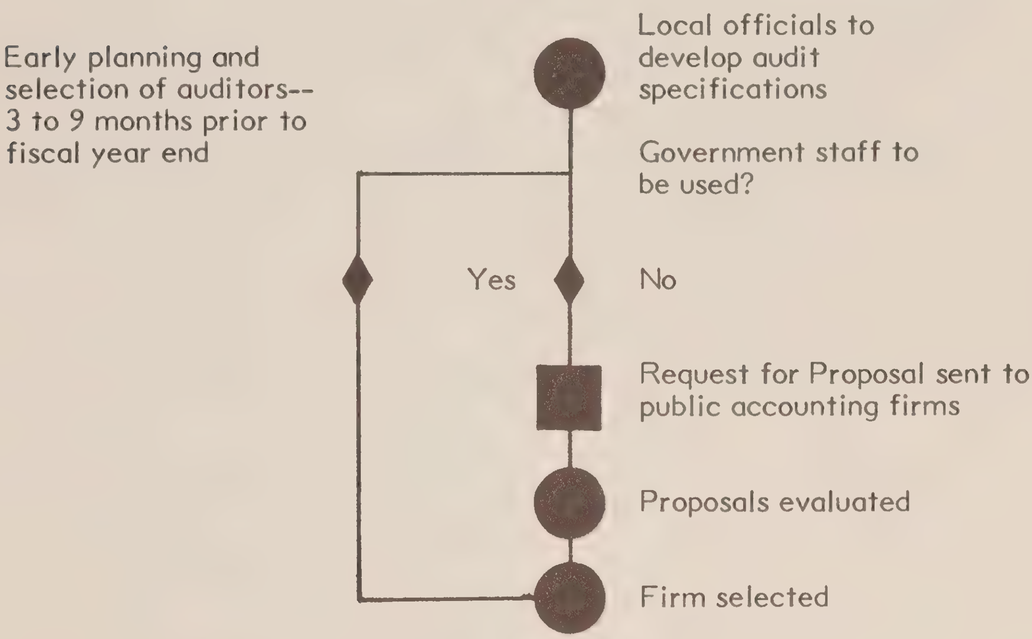
APPENDIX E

A FLOW CHART OF A TYPICAL FISCAL YEAR-END

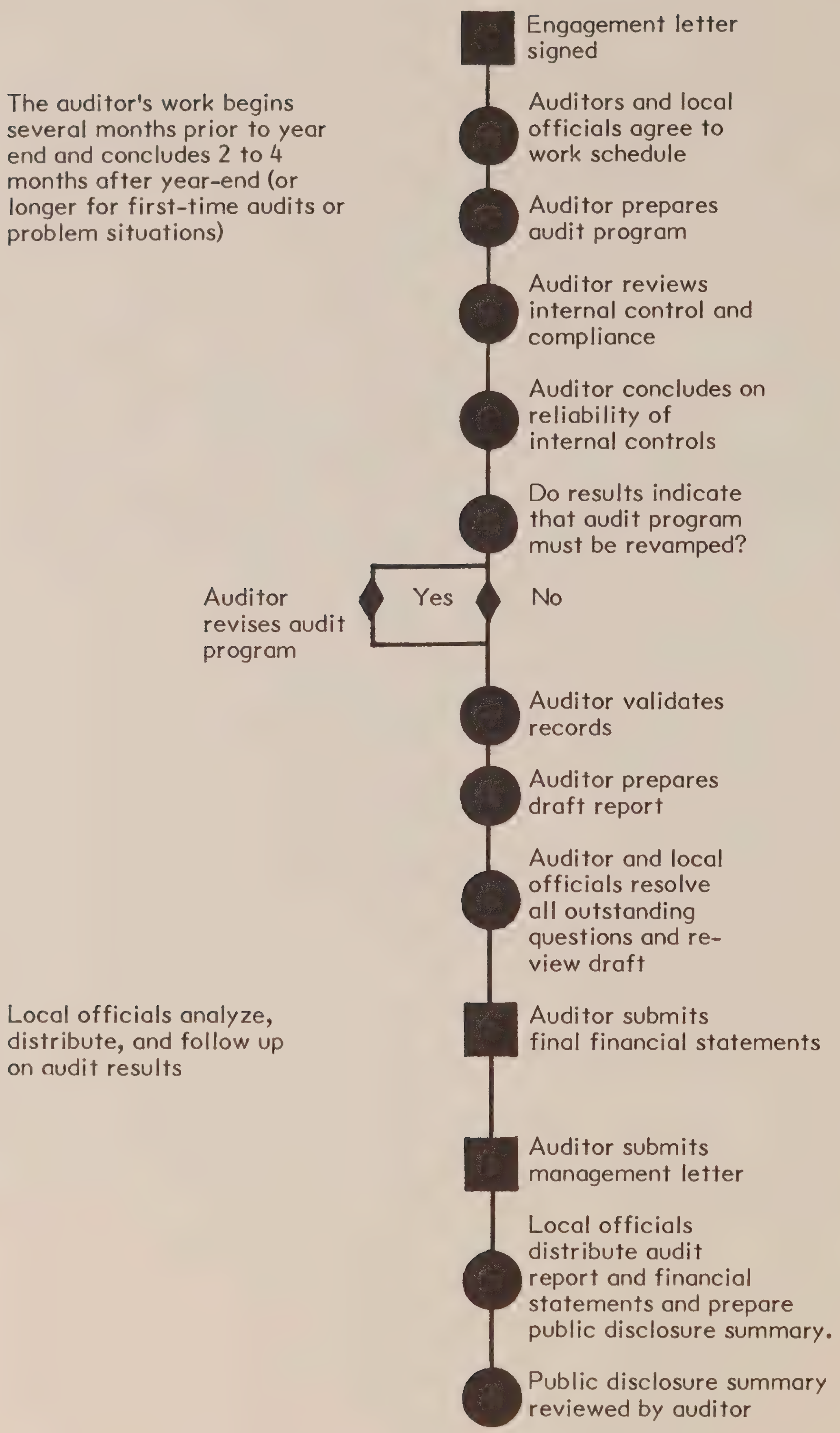
A and B should be applied where the municipality is about to change auditors.

B only should be applied where the previous auditor is being retained.

A



B



FINANCIAL DECISIONS MADE ON BASIS OF AUDIT REPORT AND MANAGEMENT LETTER.

Code: ◆ Decision ● Process ■ Report

APPENDIX F

A SAMPLE LETTER OF REPRESENTATION

(Municipality's Letterhead)

In connection with your examination of the (identification of the financial statements) of (municipality) and any boards or commissions as of (date) and for the (period of examination) for the purpose of expressing an opinion as to whether the (consolidated) financial statements present fairly the financial position of (name of municipality) and the results of its operations in conformity with generally accepted accounting principles, we confirm, to the best of our knowledge and belief, the following representations made to you during your examination.

1. We are responsible for the fair presentation in the (consolidated) financial statements of the financial position, and the results of its operations in conformity with generally accepted accounting principles, consistent with the preceding year.

2. We have made available to you all:
   a. Financial records and data; and
   b. Minutes of the meetings of the council and summaries of actions of recent meetings for which minutes have not yet been prepared.

3. There have been no:
   a. Irregularities involving management or employees who have a significant role in the system of internal accounting control;
   b. Irregularities involving other employees that could have a material effect on the financial statements; and

   c. Communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices that could have a material effect on the financial statements.

4. All inventories were priced at cost.

5. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.

6. The following have been properly recorded or disclosed in the financial statements:
   a. Related party transactions and related amounts receivable and payable, including taxes, purchases, loans, transfers, leasing arrangements, and guarantees;
   b. Investments; and
   c. Agreements to repurchase assets previously sold.

7. There are no:
   a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements; and
   b. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed.

8. There are no unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed.

9. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.

10. Provision, when material, has been made to reduce excess or obsolete inventories to their estimated net realizable value.

11. The corporation has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets.

12. We have complied with all aspects of contractual agreements that could have a material effect on the financial statements in the event of noncompliance.

13. No events have occurred subsequent to the balance sheet date that would require adjustments to, or disclosure in, the financial statements.

____

Signature--Chief Administrative Officer or Treasurer

____

Date (Date of Auditor's Report)

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